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# EITF Snapshot

Audit and Enterprise Risk Services

## November 2007

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This EITF Snapshot summarizes the November 29, 2007, meeting of the Emerging Issues Task Force.

Initial Task Force decisions ("consensuses-for-exposure") are exposed for a comment period upon ratification by the Financial Accounting Standards Board. At its first scheduled meeting after the comment period, the Task Force considers comments received and, as warranted, affirms its consensuses-for-exposure as consensuses. Consensuses are then provided to the Board for ratification.

After the December 12, 2007, FASB meeting, official EITF minutes, including the results of the FASB's ratification process, will be posted to Technical Library: The Deloitte Accounting Research Tool and to the FASB's Web site. EITF Issue summaries also can be found on those sites.

### Issue 07-1 Accounting for Collaborative Arrangements

**STATUS:** Consensus reached.

**AFFECTS:** Entities, particularly those in the biotechnology, pharmaceutical, and motion picture industries, that participate in collaborative arrangements for the development and commercialization of products; may also affect entities involved in the joint operation of a facility (e.g., those in the health care industry).

The consensus reached does not apply to a legal entity within a collaborative arrangement; however, the presence of a legal entity within a collaborative arrangement does not preclude a conclusion that a collaborative arrangement exists.

**BACKGROUND:** Entities may seek partners to share in the development and commercialization of resource-intensive (and generally uncertain) products. Although these arrangements take many forms, their substance is one of active participation by the partners (i.e., the parties to the collaborative arrangement) and a sharing of the costs and revenues of the endeavor.

Consider the following example:

Company B, a biotechnology entity, has a promising drug candidate. Company P is a pharmaceutical company with an established manufacturing facility and distribution chain. The companies enter into an arrangement for the joint development and commercialization of the potential drug. No legal entity is created; however, B and P agree that:

- B will perform the development activities.
- P will perform the commercialization activities (if and when the drug is approved for sale).
- B and P will share in the costs and revenues (if any) of the endeavor.

**SUMMARY:** The Task Force reached the following consensus:

**Issue 1** — A collaborative arrangement is a contractual arrangement in which the parties are (1) *active participants* to the arrangements and (2) exposed to *significant risks and rewards* that depend on the commercial success of the endeavor.

**Issue 2** — Costs incurred and revenues generated from *transactions with third parties* (i.e., parties outside of the collaborative arrangement) should be reported by the collaborators on the appropriate line item in their respective income statements, pursuant to Issue 99-19[1] (i.e., on the basis of whether the collaborator is a principal to the transaction). An entity should not apply the equity method of accounting under Opinion 18[2] for activities of a collaborative arrangement that are outside a legal entity.

**Issue 3** — The income statement characterization of *payments between the participants to a collaborative arrangement* should be based on other authoritative literature if the payments are within the scope of such literature. Otherwise, the income statement characterization of the payments should be based on (1) an analogy to other authoritative literature or (2) a reasonable, rational, and consistently applied accounting policy election.

**Issue 4** — The collaborators should disclose, in the footnotes to financial statements in the initial period of adoption and annually thereafter, (1) the income statement classification and amounts attributable to transactions arising from collaborative arrangements between participants for each period for which an income statement is presented and (2) information regarding the nature and purpose of the collaborative arrangement, the collaborators' rights and obligations under the arrangement, and any accounting policies for the collaborative arrangement in accordance with Opinion 22.[3]

**TRANSITION:** A consensus would be effective for fiscal years beginning after December 15, 2008, applied as a change in accounting principle through retrospective application to all periods presented for collaborative arrangements existing at the date of adoption.

**NEXT STEPS:** FASB ratification is expected at the Board's December 12, 2007, meeting.

## Issue 07-4 Application of the Two-Class Method Under FASB Statement No. 128, *Earnings per Share*, to Master Limited Partnerships

**STATUS:** Consensus-for-exposure.

**AFFECTS:** Publicly traded master limited partnerships (MLPs) with incentive distribution rights (IDRs) whose incentive distributions are accounted for as equity distributions. The consensus-for-exposure (1) does not address whether incentive distributions are equity distributions or compensation expense and (2) applies regardless of whether the IDR is a freestanding limited partner interest or embedded in the general partner (GP) interest.

The MLP ownership structure is common in industries such as petroleum and natural gas extraction and transportation.

**BACKGROUND:** In a typical publicly traded MLP, cash is distributed to common units held by limited partners (LPs), a GP interest, and IDRs, in accordance with the terms specified in the partnership agreement.

Generally, the partnership agreement obligates the GP to distribute all of the partnership's available cash[4] at the end of each quarter to the LPs, GP, and when certain thresholds are met, to the IDR holder. A complicating factor is that available cash, as determined by the partnership agreement, often differs from earnings (loss). Consequently, distributions may be greater than (or less than) earnings (loss) for any given period.

At issue is how, when applying the two-class method under Statement 128, current-period earnings of an MLP should be allocated to the GP, to the LP, and when applicable, to IDRs.

**SUMMARY:** The Task Force previously exposed this issue for public comment. After further redeliberations, the Task Force reached the following consensus-for-exposure, which will be exposed for public comment:

**Earnings in Excess of Cash Distributions** — In its consensus-for-exposure, the Task Force determined that when current-period earnings exceed cash distributions, the undistributed earnings should be allocated to the GP, to LPs, and in some cases, to the IDR holder on the basis of the contractual terms of the partnership agreement. If, based on an analysis of the contractual terms of the partnership agreement, available cash represents a "specified threshold,"[5] no allocation of

[1] EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent."
[2] APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.*
[3] APB Opinion No. 22, *Disclosure of Accounting Policies.*
[4] "Available cash" is typically defined in the partnership agreement as all cash on hand at the end of each quarter less cash retained by the partnership as capital to (1) operate the business (e.g., future capital expenditures); (2) comply with applicable law, debt, and other agreements; and (3) provide funds for distribution to the common unit, GP, and IDR holders for any one or more of the next four quarters.
[5] See Example F in paragraph 16 of EITF Issue No. 03-6, "Participating Securities and the Two-Class Method Under FASB Statement No. 128."

undistributed earnings should be made to the IDR holder. Conversely, if the contractual terms do not represent a "specified threshold," undistributed earnings should be allocated to the GP, LP, and the IDR holder on the basis of the distribution formula for available cash specified in the partnership agreement.

**Cash Distributions in Excess of Earnings** — The Task Force reached a consensus-for-exposure that when cash distributions exceed earnings (loss), net earnings (or loss) would be reduced (or increased) by the actual distributions to the GP, LPs, and IDR holder. The resulting net loss would be allocated to the GP and LPs on the basis of their respective sharing of losses specified in the partnership agreement (provided that the IDR holder is not obligated to share in the losses of the partnership).

**TRANSITION:** A consensus would be effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, applied retrospectively for all financial statements presented. Early application would not be permitted.

**NEXT STEPS:** FASB ratification is expected at the Board's December 12, 2007, meeting, after which the consensus-for-exposure will be exposed for a comment period.

## Issue 07-5 Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock

**STATUS:** No decision reached.

**AFFECTS:** Entities with (a) options or warrants on their own shares (not within the scope of Statement 150[6]), including market-based employee stock option valuation instruments,[7] (b) forward contracts to issue their own shares (including forward contracts entered into as part of an accelerated share repurchase program), and (c) convertible debt instruments and convertible preferred stock.

**BACKGROUND:** The instruments described above may contain contract terms that call into question whether the instrument or embedded feature is indexed to the entity's own stock. An instrument or embedded feature that is deemed indexed to an entity's own stock **may** be exempt from the requirements of Statement 133.[8] In addition, a freestanding nonderivative instrument that is indexed to a company's own stock remains eligible for equity classification under Issue 00-19.[9]

At issue is how an entity should determine whether an instrument is indexed to its own stock. This includes how entities should evaluate instruments when (a) the exercise price is not denominated in the entity's functional currency or (b) the shares to be exchanged at settlement are traded only on exchanges on which trades are not executed in the currency in which the exercise price is denominated.[10] Also at issue is whether an exception to the settlement approach (discussed below) should be developed for purposes of evaluating market-based employee stock option valuation instruments.

**SUMMARY:** The Task Force made no change to its previous tentative conclusion that instruments whose exercisability is affected by one or more variables other than the entity's stock price, but whose settlement is determined on the basis of a fixed number of shares for a fixed amount of consideration, are considered indexed to an entity's own stock provided that their contingency provisions are **not** based on (a) an observable market, other than the market for the entity's stock, or (b) an observable index, other than one that is solely referenced to the entity's own operations.[11] This tentative conclusion is consistent with the consensus in Issue 01-6.[12]

The Task Force discussed various alternatives to determining whether an instrument[13] is indexed to an entity's own stock. While no tentative conclusion was reached, the Task Force intends to further consider the so-called "settlement approach," in which an instrument or embedded feature would be considered indexed to an entity's own stock if its ultimate settlement amount will equal the difference between the fair value (or average fair value over a specified time period) of a fixed

[6] FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity.*

[7] For example, employee stock option appreciation rights securities or "ESOARS." See additional discussion of ESOARS in Deloitte & Touche LLP's October 24, 2007, Heads Up, "ESOARS Take Off — SEC OKs Use of a Surrogate to Value Employee Share Options."

[8] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

[9] EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

[10] Note that subissues (a) and (b) related to foreign currency exposures are addressed by the FASB in proposed Statement 133 Implementation Issue No. C21, "Scope Exceptions: Whether Options (Including Embedded Conversion Options) Are Indexed to Both an Entity's Own Stock and Currency Exchange Rates"; however, Implementation Issue C21 has been put on hold pending the Task Force's deliberations of Issue 07-5.

[11] For example, the entity's sales revenue; earnings before interest, taxes, depreciation, and amortization; net income; or total equity.

[12] EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock.'"

[13] For example, a share-settled forward contract to issue a fixed number of the entity's equity shares at a fixed strike price unless a contingent event (e.g., a change in control) occurs before the contractual settlement date. Once the contingent event occurs, the "calculation agent" may adjust the settlement amount on the basis of certain variables.

number of the entity's equity shares and a fixed strike price.[14] This approach would permit an exception when the only variables other than the entity's own stock that could affect the settlement amount are elements of the **time value** of an option or forward contract on equity shares (for example, interest rates).

The Task Force did not deliberate how entities should evaluate foreign currency exposures (described above), nor did it discuss whether an exception to the settlement approach should be developed for purposes of evaluating market-based employee stock option valuation instruments.

**NEXT STEPS:** The Issue 07-5 working group will continue to discuss the settlement approach at an upcoming meeting. Further discussion by the Task Force is expected at the March 2008 EITF meeting.

## Issue 07-6 Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66, *Accounting for Sales of Real Estate*, When the Agreement Includes a Buy-Sell Clause

**STATUS:** Consensus reached.

**AFFECTS:** Entities (investors) that transfer real estate to a venture that they jointly own with another investor when the joint-ownership agreement contains a "buy-sell clause."

**BACKGROUND:** When two investors enter into an arrangement to create a jointly owned venture and one investor (the "selling investor") transfers real estate to that entity, the agreement commonly includes a buy-sell clause. A buy-sell clause permits either investor (the "offeror") in the jointly owned entity to irrevocably request a buyout of the other investor's (the "offeree's") entire interest by providing a notice (the "purchase notice") to the offeree.

In the purchase notice, the offeror typically names a price for the offeree's interest at its discretion. After receiving the purchase notice, the offeree **must** either (1) sell its entire interest in the venture to the offeror or (2) buy the offeror's interest at the named price. This example is known as an "unspecified-price" buy-sell clause. Other, less common, types of buy-sell clauses exist.

At issue is whether a buy-sell clause represents a prohibited form of continuing involvement (e.g., an option to reacquire the real estate) under Statement 66 that precludes partial sale-and-profit recognition upon transfer of the real estate to the venture by the selling investor.

**SUMMARY:** The Task Force reached a consensus that a buy-sell clause, in and of itself, does not constitute a prohibited form of continuing involvement that would preclude partial sale-and-profit recognition under Statement 66. However, the terms of the buy-sell clause, along with other facts and circumstances, may indicate that the seller has **not** transferred the usual risks and rewards of ownership and therefore has substantial continuing involvement. The determination of whether the seller has substantial continuing involvement is a matter of judgment and requires consideration of all relevant facts and circumstances of the transaction at the time the real estate is sold.

**TRANSITION:** If ratified by the FASB, a consensus would be applied prospectively to new arrangements entered into and assessments[15] performed in fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Early application would not be permitted.

**NEXT STEPS:** FASB ratification is expected at the Board's December 12, 2007, meeting.

## Administrative Matters

Issues 98-5[16] and 00-27[17] address the accounting for convertible securities with beneficial conversion features or contingently adjustable conversion ratios. The Task Force discussed the FASB staff's proposed approach to updating Issue 98-5 for the consensuses in Issue 00-27 and the issuance of Statement 150. The Task Force asked the FASB Staff to consider alternative approaches for updating Issue 98-5, including an approach that would in effect codify Issues 98-5 and 00-27. The Task Force indicated that any approach should leave a historical record of Issue 98-5 as there may be convertible instruments still subject to its guidance. Further discussion is expected at the Task Force's March 2008 meeting.

[14] Standard antidilution provisions would not preclude an instrument or embedded feature from being indexed to an entity's own stock. Standard antidilution provisions are those that result in adjustments to the strike price in the event of an equity restructuring (as defined in the glossary of FASB Statement No. 123(R), *Share-Based Payment*) and that are designed to maintain the value of the instrument or embedded feature.

[15] In this context, assessments can be defined as any evaluation performed pursuant to Statement 66 after the effective date of Issue 07-6 for arrangements accounted for under the deposit, profit-sharing, leasing, or financing methods for reasons other than the existence of a buy-sell clause.

[16] EITF Issue No. 98-5, "Accounting for Convertible Securities With Beneficial Conversion Features or Contingently Adjustable Conversion Ratios."

[17] EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments."

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